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No.

In the Supreme Court of The United States

OCTOBER TERM, 1996

EDWARD E. ROBINSON AND SANDRA ROBINSON,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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STATEMENT OF THE QUESTION

Whether damages allocated to personal injury received from a settlement after a State court jury trial are excludable under Internal Revenue Code section 104(a)(2) as damages resulting from tort or tort-like action and sustained on account of personal injuries.

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TO THE UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

Edward E. Robinson and Sandra Robinson petition for a writ of certiorari to review the judgement of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (Appendix A, *infra*) is published at Robinson v. C.I.R., 70 F.3d 34. The opinion of the Tax Court (Appendix B, *infra*) is published at Robinson v. Commissioner, 102 T.C. 16.

JURISDICTION

Judgment of the court of appeals was entered on December 5, 1995. The jurisdiction of this court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

2. Section 104(a) of the Internal Revenue Code, 26 U.S.C. 104(a), provides in relevant part:

> Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include--
>
> *******
>
> (2) the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness.

STATEMENT OF THE CASE

In 1987, the Petitioners (hereinafter "Petitioners" or "the Robinsons") recovered a judgment against Texas Commerce Bank ("the Bank") in McAllen, Texas in the approximate amount of $60,000,000. In the second amended petition filed in the State Court action, the Petitioners alleged in part that the Defendant's failure to release a lien on their property was willful, an act of malice, in reckless and conscious disregard of Petitioners' rights, based on false representations, tortious and a cloud on their title. Petitioners prayed for the following damages among others: (1) Lost profits of $20 million, (2) $250,000 for losses that petitioners incurred on forced sales of properties other than the piece of property foreclosed on, (3) $200,000 for amounts incurred by Petitioners in their attempt to save their business, (4) $5 million for severe mental anguish suffered by Petitioners before trial, (5) $5 million for future severe mental anguish (6) exemplary (punitive) damages of five times the amount of actual or compensatory damages awarded in the case, (7) attorney fees proven at trial.

Approximately one month after trial the jury returned its verdict awarding Petitioners actual damages as follows: $6 million in lost profits; $175,000 in out of pocket expenses, $85,000 damage to credit reputation; $1 million for mental anguish suffered by Petitioner Sandra Robinson; $500,000 damages for mental anguish suffered by Petitioner Edward Robinson; $1.5 million in attorney fees; and $50 million in

exemplary damages.

The jury found in relevant part that: (1) Petitioners did not expressly or impliedly agree to give the bank a lien on the foreclosed upon property; (2) the Bank made fraudulent misrepresentations; (3) the Bank's fraudulent misrepresentations were the proximate cause of damages to the Petitioners; (4) the Bank did not act in good faith in its dealings with Petitioners; (5) Bank's failure to act in good faith was the proximate cause of Petitioners' damages; and (6) Bank's conduct was intentional, willful and in wanton disregard of Petitioners' rights.

After the verdict, between May 20, 1987, and July 30, 1987, counsel for Petitioners and the Bank engaged in settlement discussions. On July 30, 1987, Petitioners and the Bank agreed to a settlement. The settlement provided the Bank would pay the Petitioners $10 million in cash and release a lien on Petitioners' other property of $691,972 in exchange for release of liability on all claims that Petitioners had against the Bank. The parties then prepared a "Final Judgment" which was presented to and signed by the trial court judge at his home. The Final Judgment allocated 95% of the settlement to mental anguish suffered by the Robinsons and 5% to lost profits. There was no evidence that indicated that the trial court judge acted improperly in any way.

The Final Judgment was entered by the trial court on July 31, 1987 and vacated the judgment entered on May 20, 1987. By check

dated August 4, 1987, Petitioners received their $4,935,151.72 share of the $10 million payment (the remaining $5,064,848.28, went to Petitioners' attorneys). Petitioners reported $246,758 of the settlement proceeds, or 5% of the $4,935,151.72 on their 1987 form 1040 as miscellaneous income. Petitioners did not report any of the $691,972.43 release on their 1987 form 1040.

On July 25, 1991, the Commissioner of the Internal Revenue asserted a deficiency in the Robinsons' income tax for 1987 of $1,579,549, and a deficiency of $90,800 for 1988. During trial the Commissioner requested and was granted the right to amend its pleadings to assert an additional deficiency of $691,972.43, resulting from the release of a judgment owed by the Robinsons to the Bank as a part of the overall settlement.

In the notice of deficiency, the Commissioner stated that for 1987, 95% of the judgment was taxable and should have been included in gross income resulting in an additional $4,441,637 added to Petitioners' 1987 gross income. Because of the additional income' a Net Operating Loss carry forward from losses in 1987 was disallowed in 1988, resulting in a $305,182 increase in taxable income in 1988.

Petitioners filed a petition for review of the asserted deficiency in the United States Tax Court. The case was tried before the Honorable David Lara on February 23, 1993.

Judge Lara filed his opinion in the case on February 2, 1994, holding that the Commissioner was not bound by the allocation of damages in the State Court judgment and that only 37.331% of the judgment should be allocated to tort-like injuries qualifying for exclusion under section 104(a)(2) of the Internal Revenue Code. The Court further held that the Commissioner could amend his pleadings to include the additional $691,972.43 of income resulting from the Bank's release of a separate lien on another piece of Petitioners' property.

Petitioners then appealed to the Fifth Circuit Court of Appeals. The Fifth Circuit opinion delivered by the Honorable Reynaldo G. Garza, further reduced the amount of damages excludable under section 104(a)(2) to only 15%. The court concluded that only approximately 15% of Petitioners damages were on account of personal injury. Robinson v. C.I.R., 70 F.3d 34, 36 (5th Cir. 1995). The Fifth Circuit looked to the State Court judgment and determined that because the judgment was reached in a non-adversarial proceeding the Tax Court was not bound by the State Court judgment. Id. at 37. Additionally, the Court concluded that the Tax Court did not err in refusing to subpoena the state trial court judge to testify as to the validity verdict. Id. at 38. The Court also concluded that the Tax Court did not err in its refusal to reopen the record. Id. at 39.

REASONS FOR GRANTING THE PETITION

The Fifth Circuit Court of Appeals has issued an opinion upholding a Tax Court

opinion decided in conflict with two opinions issued by the United States Supreme Court. The Fifth Circuit decided Petitioners' personal injury judgment was taxable without following the procedure outlined by this Court in United States v. Burke, 504 U.S. 229 (1992). In Burke, this Court concluded that when determining whether damages should be excluded from income under section 104(a)(2) of the Internal Revenue Code, courts must focus on the nature of the claim underlying the damage award.

In its reallocation of damages both the Tax Court and the Fifth Circuit ignored the underlying cause of action to the Robinsons' claim. Both Courts deemed most of the Robinsons' claim was taxable because they were not bound by the decisions of the State trial court. After such a determination, the Courts looked only to the vacated jury verdict to conclude most of the Robinsons' damages were taxable.

This reasoning directly conflicts with the procedure outlined in Burke. Burke requires looking at the nature of the claim asserted in determining the type of damages awarded. The nature of the claim underlying Petitioners' damage award is a "tort or tort-like" claim resulting in personal injuries. If the Courts below had followed Burke, then both Courts should have realized that the Petitioners' claim was clearly a tort claim which resulted in personal injuries supporting the settlement. Therefore, under Burke Petitioners' claim is excludable under section 104(a)(2) of the Internal Revenue Code.

In addition, in deciding the Robinsons' damages were taxable, both Courts misunderstood this Court's position in Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). The Courts relied on the non-adversarial proceeding standard that Bosch specifically considered and rejected. To compound the error, the Courts failed to give the State Court judgment "proper regard" mandated by Bosch.

Absent further review by this Court, the Petitioners' personal injury damages which should be excluded under section 104(a)(2) will remain taxable. This results in unfair tax treatment to the Petitioners and possibly any other taxpayers who receive a settlement verdict for personal injuries.

1. Section 104(a)(2) of the Internal Revenue Code provides that gross income does not include "the amount of any damages received (whether by suit or agreement . . .) on account of personal injuries or sickness. In United States v. Burke, 540 U.S. 229, 237 (1992), this Court stated that for purposes of the section 104(a)(2) income exclusion, the analysis should focus on the "nature of the claim underlying the respondent's damages award." In order to be excluded from gross income, the damages must redress a tort-like personal injury.

In Burke, this Court recognized that "common law tort concepts are helpful in deciding whether a taxpayer is being compensated for 'personal injury'". Id. at 234 (quoting Threlkeld v. Commissioner, 87 T.C. 1294, 1305 (1986) (internal quotation

marks omitted), aff'd F.2d 81 (6th Cir. 1988). In acknowledging the common law tort as the starting point the court elaborated several distinguishing features of a tort."'[A]n action for damages' is 'an essential characteristic of every true tort,' and even where other relief, . . ., may be available, 'in all such cases it is solely by virtue of the right to damages that the wrong complained of is classified as a tort'". Id. at 235, (quoting R. Heuston, Salmond on the Law of Torts, 9 (12th ed. 1957)). "Indeed, one of the hallmarks of traditional tort liability is the availability of a broad range of damages to compensate the plaintiff 'fairly for injuries caused by the violation of his legal rights.'" Id. at 235 (quoting Carey v. Piphus, 435 U.S. 247, 257 (1978). This Court recognized that a tort victim may recover for "any actual pecuniary loss" as well as "for impairment of reputation and standing in the community, personal humiliation, and mental anguish and suffering." Id. at 236, 237 (quoting Gertz v. Robert Welch, Inc., 418 U.S. 323, 350 (1974). "Furthermore, punitive or exemplary damages are generally available where the defendant's misconduct was intentional or reckless." Id. at 236 (citing D. Dobbs, Law of Remedies, 204-208 (1973)).

The Petitioners' claim contains all of the distinguishing features that this Court recognizes constitute a tort. The defendant Bank refused to release its lien and wrongfully foreclosed on the property. Petitioners' second amended petition alleged, in part, that the defendant's failure to release the lien was willful,

malicious, in reckless disregard of Petitioners' rights, unconscionable, based on false representations, tortious and a cloud on title. The petitioners prayed for, among other relief, $5 million for severe mental anguish suffered before trial, $5 million for future severe mental anguish and exemplary or punitive damages of five times the amount of actual or compensatory damages awarded in the case. Robinson v. Commissioner, 102 T.C. 116, 120 (1992).

After hearing the case, the jury found that the Bank had made fraudulent misrepresentations, had not acted in good faith and proximately caused the damages suffered by the taxpayers. Additionally, the jury found the Bank's conduct was intentional, willful and in wanton disregard of the Robinsons' rights. Testimony during trial indicated that the Robinsons' suffered severe emotional distress resulting in Sandra Robinson being hospitalized for psychological problems during trial. She testified the defendant Bank caused her illness by wrongfully foreclosing on the property and ruining their business.

Petitioners' claim resulted from the deliberate wrongful and forcible taking of the taxpayers' property. The jury found the Bank's actions proximately caused the taxpayers' personal injuries. Robinson, 102 T.C. 116, 121. The claim resulted in a broad range of damages. The jury award included $6 million in lost profits, and $1.5 million in past and future mental suffering. It also included damages to Petitioners' personal reputation in the community and attorney fees. In addition the

jury awarded $50 million in punitive damages for the defendant's reckless and intentional misconduct. Id. at 121. The wrongful foreclosure on the property is a tort claim which underlies the taxpayers' damage award. The petitioners' claim includes the broad range of damages which hallmark a traditional tort claim: pain and suffering damages, actual and pecuniary losses, reputation damages, and punitive damages.

To avoid a lengthy appeals process, both sides agreed to settle the suit. Petitioners and the Bank agreed to a $10 million settlement. The Final Judgment signed by the trial court judge allocated 95% of damages to personal injuries suffered by the Petitioners, less than what the Petitioners prayed for in their amended complaint. The settlement allocated the other 5% to damages resulting from lost profits.

In Burke this Court stated and the Commissioner agreed that in determining whether damages were received on account of tort-like personal injuries, the focus should be on the "nature of the claim underlying the [taxpayers'] damage award." Burke, 504 U.S. 229, 237. The nature of the Robinsons' suit against Texas Commerce Bank was clearly based on a tort action. This tort action (the wrongful taking of Petitioners' land) resulted in and proximately caused the Petitioners' personal injuries. The settlement reached by the parties reflects the Petitioners' position that the claim was based on a tort resulting in personal injuries.

To determine the nature of the claim underlying the damage award the Tax Court relied on Knuckles v. Commissioner, 349 F.2d 610, 613 (10th Cir. 1965). The Tax Court concluded that "such a determination is factual and is generally made by reference to the settlement agreement." 102 T.C. 116, 126. The Tax Court continued to rely on Knuckles in declaring that "an important factor in determining the validity of the agreement is 'the intent of the payor' in making the payment. 102 T.C. 116, 127 (quoting Knuckles at 613).

The Tax Court and Fifth Circuit misinterpreted Knuckles. Knuckles held that the facts and circumstances and the "intent of the payor" might be relevant for such a determination, "*in the absence of an express personal injury settlement agreement.*" Knuckles, 349 F.2d 610, 613 (emphasis added). With a personal injury settlement, the courts should look to the agreement to determine the nature of the claim. The Robinsons' tort claim resulted in an express personal injury settlement agreement entered as a valid State Court judgment. Under Knuckles, the personal injury settlement agreement must stand.

The Tax Court's interpretation of Threlkeld v. Commissioner, 87 T.C. 1294, 1306-1307 (1986), aff'd. 848 F.2d 81 (6th Cir. 1986) is also in direct conflict with this Court's holding in Burke. The Tax Court uses Threlkeld to leap from analyzing the nature underlying the Petitioners' claim to drawing conclusions based solely on the jury verdict. The Tax Court reads Threlkeld as requiring that the agreement be "entered

into by the parties in an adversarial context at arm's length and in good faith." Such reading is erroneous.

First, Threlkeld did not consider whether the parties entered into the agreement in an adversarial proceeding; rather it was a suit in which the Tax Court was asked to determine whether damages received in a State based claim for malicious prosection were excludable as personal injuries. The court looked to various factors such as "allegations in the State court pleadings, the evidence adduced at trial, [and] a written settlement agreement" to determine whether the damages were on account of personal injury. Id. at 1306. There is no reference to whether the settlement agreement was reached in a non-adversarial proceeding. Furthermore, the Court's reliance on the non-adversarial proceeding standard was specifically considered and rejected by this Court in Commissioner v. Estate of Bosch, 387 U.S. 456 (1967) (discussed *infra*).

Second, the Tax Court and the Fifth Circuit ignored the factors listed in Threlkeld. Threlkeld supports the Robinsons' position and this Court's holding in Burke. The Court in Threlkeld examined the nature of the claim underlying the petitioner's damage award. For evidence of the underlying claim the Court looked primarily "to the petitioner's allegations in his complaint in the State court." Threlkeld, 87 T.C. 1294, 1307. Furthermore, similar to the Robinsons' claim, the petitioner's complaint in Threlkeld alleged a tort claim which resulted in personal

injuries which were held excludable under section 104(a)(2).

The factors cited in Threlkeld and Burke all lead to the conclusion that the Robinsons' suffered personal injuries on account of the Bank's tortious conduct. The written settlement provides relief for past pain and suffering borne by the Petitioners. Petitioners' pleadings included more for pain and suffering than the settlement agreement actually provided. The evidence adduced at trial supports both the pleadings and the written settlement agreement.

The Tax Court opinion stated that "Petitioners' counsel determined this allocation solely to minimize the amount of taxes the petitioners would have to pay." Robinson, 102 T.C. 116, 124. It is true the Petitioners wanted to minimize their taxes; however, this was not the only consideration in making the allocation. The Petitioners prayed for and suffered enough personal injuries to justify such a settlement. Evidence at trial showed that as a result of the Bank's actions, Sandra Robinson suffered extreme emotional distress. Sandra Robinson was hospitalized for nearly two weeks. She suffered a nervous breakdown and was unable to sit through the entire trial. Even the trial court judge agreed that he saw a lot of mixed feelings and emotional stress. "The Petitioners' trial was one of the longest trials in which he had been involved, their trial was stressful to him and to other members of the jury." Robinson, 102 T.C. 116, 121 (fn 8). He felt comfortable with allocation of the settlement: 95% to mental anguish and 5% to

lost profits.

Both the Tax Court and the Fifth Circuit failed to follow the proper procedure outlined by this court in Burke. The Fifth Circuit stated that the allocation "based upon the jury verdict, [is] the best indication of the worth of the Robinsons' claim." Robinson v. C.I.R., 70 F.3d 34, 38 (1995). Such a position is clearly erroneous and completely contradicts Burke. Burke mandates looking directly to the nature of the claim underlying the damages award for personal injury. The Tax Court and the Fifth Circuit looked only at the jury verdict rather than analyzing the nature of the claim behind the Robinsons' damage award. If the Courts had followed Burke, then both Courts should have realized that clearly the Robinsons' claim was a tort claim based upon personal injuries large enough to support the agreed settlement. Therefore, under Burke the Petitioners' claim is excludable under section 104(a)(2) of the Internal Revenue Code.

2. Since Burke, this Court decided Commissioner of Internal Revenue v. Schleier, 112 S.Ct. 2159 (1995). In Schleier this Court added a second prong to the test announced in Burke. "First, the taxpayer must demonstrate that the recovery is based upon 'tort or tort type rights'; and second the taxpayer must show that the damages were received 'on account of personal injuries or sickness.'" Id. at 2168. Part of the analysis in Schleier is the link between the personal injury and the damages recovered. Id. at 2164. Petitioners' settlement fits perfectly

within the framework outlined by this Court in Schleier. The nature of the claim was clearly based on "tort or tort type rights" which proximately caused Petitioners' personal injuries. The personal injuries consisted of pain and suffering and severe emotional stress. The State Court-approved settlement awarded the Robinsons' damages for pain and suffering caused by the defendant Bank's conduct. The damages awarded are directly linked to the pain and suffering endured by the Petitioners.

Schleier used a hypothetical tort settlement to describe the types of damages which fall under the section 104(a)(2) income exclusion. Medical expenses incurred and lost wages "clearly constitute damages received 'on account of personal injury.' Similarly, the portion of the settlement intended to compensate for pain and suffering constitutes damages 'on account of personal injury.'" Id. at 2164. Although Petitioners' claim differs some from the car accident victim used in the hypothetical, the Court recognized that section 104(a)(2) excludes recoveries based on intangible as well as tangible harms. Id. at 2164 fn.4 (quoting Burke, 540 U.S. at 235 (SCALIA J., concurring in judgment)(acknowledging that "'personal injuries or sickness'" includes nonphysical injuries)).

Petitioners have both physical and emotional harms. The severe emotional trauma took such a toll on Sandra Robinson that she was physically hospitalized. Additionally, Eddie Robinson suffered through the emotional pain any person would suffer when his or her spouse is

hospitalized. The settlement intended to compensate Petitioners for such pain and suffering. Clearly the Petitioners' damages fall within the "on account of personal injury prong" set forth in Schleier and should be excluded from income.

3. If it is necessary to look to the State Court judgment after reviewing the nature of the claim, that State Court judgment should be given "proper regard." Commissioner v. Estate of Bosch, 387 U.S. 456 (1967). The Fifth Circuit ruled that because the Tax Court found that the allocation was not entered in a non- adversary proceeding, the Tax Court need not consider itself bound by the proceeding. The Fifth Circuit reasoned that because this was a finding of fact, it would only disturb this ruling upon a clear finding of error. In finding the Robinsons' award taxable, the Fifth Circuit contravened Bosch by upholding the non-adversary standard and failing to give the State Court judgment "proper regard."

The Fifth Circuit's promulgation of the non-adversary proceeding standard conflicts with this Court's holding in Bosch. In Bosch, this Court specifically addressed and rejected the non-adversary proceeding approach. The Government's position in Bosch was that a "state trial court adjudication is binding in such cases only when the judgment is the result of an adversary proceeding in the state court." 387 U.S. 456, at 463. The Court rejected the non-adversary standard and opted instead for the "proper regard" approach. "If there be no decision by that [State's highest] court then the federal authorities must apply what

they find to be State law after giving 'proper regard' to relevant rulings of other courts of the state." Id. at 465. The Court stated that this rule "would avoid much of the uncertainty that would result from the 'non-adversary' approach and at the same time would be fair to the taxpayer . . . ." Id. at 465. In the Robinsons' case the Fifth Circuit upheld the Tax Court's disregard of the State judgment because it found that "the Robinsons and the bank were not adversarial in the allocation of the settlement proceeds." Robinson v. C.I.R., 70 F.3d 34, 38. The Fifth Circuit's approval of the non-adversary standard is erroneous under Bosch. Instead, Bosch requires "proper regard" for the Robinsons' State Court judgment.

Both the Tax Court and the Fifth Circuit completely ignored the "proper regard" standard. The Tax Court reallocated the State Court judgment from 95% damages awarded for pain and suffering to only 37.331% awarded for pain and suffering. The Fifth Circuit further reduced the State Court judgment of 95% to only 15% damages for pain and suffering. It is true under Bosch that the federal courts are not bound by State lower court proceedings. However, neither the Tax Court nor the Fifth Circuit gave the State court judgment "proper regard". They simply determined the settlement was reached in a non-adversarial proceeding, completely disregarded the State Court judgment, and then freely allocated the Petitioners' damage award based solely on the vacated jury verdict ignoring the underlying nature of the claim.

Where a State trial judge is fully aware of the competing State law claims of the parties as was the case here, "proper regard" requires that, barring some evidence that the State trial court judge manipulated the tax consequences or improperly lent his office to such manipulation, his determination of State law should control. The record contained no evidence that the trial judge improperly manipulated the tax consequences or lent his office to such manipulation.

The State courts themselves are uniquely situated and competent to determine State law rights, especially when, as here, the facts demonstrate that they are fully informed of the facts and laws. It should not be assumed that the Tax Court could make a better decision, by collateral attack in a proceeding years later, than a State judge fully informed of the facts and law on the scene when the determination was made. The trial court judge was in the best position to understand the nature of the claim, the injuries suffered and how damages should be allocated. Therefore, judgment of Judge Evins should be given great weight.

The Commissioner offered no evidence other than the fact that the Final Judgment was signed by the judge at his home to refute the judge's determinations. The fact that the Judge signed the judgment at his house in no way reflects upon his understanding that the facts and circumstances supported such a judgment. Furthermore, the Commissioner offered no evidence to indicate that Judge Evins acted incorrectly or improperly by signing the

Final Judgment.

By upholding the Tax Court judgment, the Fifth Circuit twice contradicted this Court's holding in Bosch. Bosch rejected the non-adversarial standard used by the Tax Court and the Fifth Circuit in reaching their decisions about the validity of the State Court judgment. The Tax Court simply determined that because the settlement was reached in a non-adversarial proceeding, the federal courts are not bound by it. Although the federal courts are not bound by a State trial court judgment, "proper regard" must mandate something more than total disregard of the judgment. If the State Court judgment was given "proper regard" under Bosch, combined with consideration of the other factors enumerated by this Court in Burke, clearly the judgment of the trial court should be upheld.

4. The Tax Court and the Fifth Circuit have decided a case in conflict with two cases decided by this Court. By disregarding the procedures outlined in both Burke and Bosch, these Courts have unjustly imposed a severe tax liability upon the Petitioners. In the absence of a hearing from this Court the income awarded to Petitioners in settlement of a tort claim resulting in personal injury, will remain taxable despite the section 104(a)(2) exclusion which should pertain to such injuries.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully Submitted.
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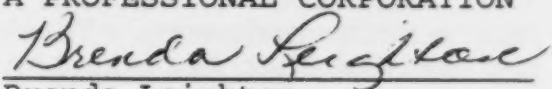

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APPENDIX A

Edward E. ROBINSON & Sandra Robinson,
Petitioners-Appellees, Cross-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant, Cross-Appellee.

No. 94-41023.

United States Court of Appeals,
Fifth Circuit.

Dec. 5, 1995.

Taxpayers' petitioned for redetermination of income taxes owed on settlement proceeds. The Tax Court, 102 T.C. 116, 1994 WL 26303, allocated settlement proceeds based on relationship of certain amounts awarded to taxpayers by jury. Commissioner of Internal Revenue appealed and taxpayers cross-appealed. The Court of Appeals, Reynaldo G. Garza, Circuit Judge, held that: (1) portion of taxpayers' settlement proceeds allocable to punitive damages was not excludable from their gross income as damages received for personal injuries or sickness; (2) allocation of settlement proceeds was not entered into in adversary proceeding; and (3) taxpayers were not entitled to reopening of record to allow them to present evidence of deductions that offset discharge-of-indebtedness income.

Affirmed in part, reversed in part and remanded.

1. Internal Revenue - 3123,3124

Portion of taxpayers' settlement proceeds allocable to punitive damages was not excludable from their gross income as damages received for personal injuries or sickness, as punitive damages awarded under Texas law were not intended to compensate. 26 U.S.C.A. Section 104(a)(2).

2. Internal Revenue - 3123, 3124

Allocation of settlement proceeds between compensatory and punitive damages was not entered into in adversary proceeding, so that proceeds could be reallocated for income tax purposes, in view of testimony of attorneys who represented taxpayers in settlement that defendant allowed taxpayers to allocate settlement proceeds in any manner they wished. 26 U.S.C.A. Section 104(a)(2).

3. Internal Revenue - 3123

For income tax purposes, allocation of settlement proceeds based upon jury verdict was proper. 26 U.S.C.A. Section 104(a)(2).

4. Internal Revenue - 4710

Court of Appeals reviews Tax Court's quashing of subpoena for abuse of discretion.

5. Witnesses - 71

Judge may not be asked to testify about his mental processes in reaching judicial opinion.

6. Witnesses - 4

Taxpayers were not entitled to subpoena state court judge to testify as to his understanding and knowledge of settlement agreement and its allocation of settlement proceeds between compensatory and punitive damages, in taxpayers' petition for redetermination of income taxes owed on proceeds, where there was no way that trial judge could have been asked about such matters without delving into his mental processes. 26 U.S.C.A. Section 104(a)(2).

7. Federal Courts - 823

Denial of motion to reopen record for admission of additional evidence is not subject to review except upon determination of extraordinary circumstances which reveal clear abuse of discretion; further, such motions should be denied where evidence to be presented was available at trial, or could have been obtained with reasonable diligence.

8. Internal Revenue - 4666.1

Taxpayers were not entitled to reopening of record to allow them to present evidence of deductions that offset discharge-of-indebtedness income, where, through exercise of reasonable diligence, taxpayers could have obtained evidence of offsetting deductions and where taxpayers were made aware through both Commissioner of Internal Revenue's interrogatories and through evidence obtained during depositions that discharge-of-indebtedness income was issue in case.

Appeal from a decision of the United States Tax Court.

Before REYNALDO G. GARZA, GARWOOD and DUHE, Circuit Judges.

REYNALDO G. GARZA, Circuit Judge:

I.

BACKGROUND

Edward and Sandra Robinson obtained a $60,000,000 jury verdict against a bank for wrongful failure to release a lien. This $60,000,000 included $6,000,000 for lost profits, $1,500,000 for mental anguish, and $50,000,000 in punitive damages. The Robinsons then settled their claims against the bank for $10,000,000 plus the release of a judgment that the bank held against the petitioners in the amount of $691,972.43 while the trial court was considering the bank's motion for a new trial. In the final judgment reflecting the settlement, which was drafted by the parties and signed by the trial judge, 95% of the settlement proceeds were allocated to mental anguish and 5% were allocated to lost profits.

The Robinsons received $4,935,152.43 of the settlement proceeds after paying attorneys' fees and costs. Of that amount, they only reported five percent of the proceeds ($246,758) - the amount allocated to lost profits - as income on their 1987 joint income tax return. They contended that the other 95% was excludable under Section 104(a)(2) of the Internal Revenue Code as "damages received...on account of personal injuries or sickness."[1]

The Internal Revenue Service ("IRS") considered 95%, rather than 5% of the proceeds to be taxable, and recomputed the Robinsons' taxable income by adding 90% of the proceeds received by the Robinsons ($4,400,000). This added income eliminated a carried forward net-operating-loss deduction claimed in the 1988 tax year, and the IRS noticed deficiencies for the 1987 and 1988 tax years. The Robinsons then petitioned the Tax Court for redetermination, arguing that 95% of the settlement proceeds were excludable under Section 104.

At trial, the IRS discovered and asserted an additional deficiency based on the Robinson's discharge-of-indebtedness income from the bank's release of the $691,972.43 judgment in conjunction with the settlement. The Tax Court allowed the IRS to amend its pleadings to assert this discharge-of-indebtedness income.

After hearing the evidence and the parties' arguments, the Tax Court rendered judgment. It first found that the allocation of the settlement proceeds did not reflect the damages that the Robinsons suffered. Instead, the Robinsons were allowed to allocate the settlement proceeds in a manner that minimized their tax liability. The Tax Court therefore refused to recognize the allocation contained in the final judgment, and reallocatd the settlement proceeds among the various elements of damages that the jury awarded the Robinsons in their suit against the bank.

The Tax Court allocated the settlement proceeds based on the relationship of

certain amounts awarded to the Robinsons by the jury. Because the Tax Court agreed that the punitive damages may have been reduced on appeal, it first allocated the proceeds based on the amounts awarded by the jury for compensatory damages. It then allocated the remaining balance to punitive damages. Using this method, the Tax Court allocated the proceeds as follows:

	Damages	Percentage of damages
Actual Damages:		
Lost Profits	$6,000,000	60.893
Other Business Damages	175,000	1.776
Injury to Credit Rep.	85,000	.863
Mental Anguish	1,500,000	15.223
Punitive Damages:	2,093,360	21.245
Settlement Less Prejudgment Interest	$9,853,360	100.000
Prejudgment Interest	146,640	
Total Settlement Payment	$10,000,000	

The Tax Court then allocated the settlement proceeds based on the percentage of damages attributed to each item of damage. It therefore allocated 37.331% of the proceeds - the amounts attributable to punitive damages (21.245%), mental anguish (14.223%) and injury to credit reputation (.863%) - to damages for tort-like personal injuries. The Tax Court then held that $1,787,59.30 - the 37.331% of the net payment (less prejudgment interest)[2] attributable to tort-like injuries - was excludable under Section 104, and that the balance of the net payment (including prejudgment interest) was includable in the

Robinsons' 1987 gross income.

The Commissioner of Internal Revenue then appealed the Tax Court's exclusion of the portion of settlement proceeds allocable to punitive damages. The Robinsons cross-appealed, arguing that the Tax Court erred in its allocation of the proceeds, its refusal to subpoena the trial judge who presided over their suit against the bank, and its refusal to reopen the record to allow them to demonstrate deductions that would offset the discharge-of-indebtedness income.

II.

THE COMMISSIONER'S APPEAL

[1] The Tax Court held that the portion of the Robinsons' settlement attributable to punitive damages was excludable from their gross income as "damages received...on account of personal injuries or sickness" under Section 104(a)(2) of the Internal Revenue Code.[3] The Commissioner appeals from this holding, arguing that, because they are not intended to compensate plaintiffs for personal injuries, punitive damages are not excludable from gross income under Section 104(a)(2). This Court recently held that punitive damages awarded under Texas law are not intended to compensate, and are therefore not excludable under Section 104(a)(2).[4] Accordingly, we reverse the Tax Court on this issue and hold that the portion of the Robinsons' settlement proceeds allocable to punitive damages are not excludable under Section 104(a)(2).

Because the proceeds allocable to punitive damages are not excludable, the

Robinsons must include the 24.241% of $4,788,511.72, the net settlement payment (less prejudgment interest,[5] as well as 24.241% of the $691,972.43 discharge of indebtedness. However, because the parties agreed that the Robinsons were allowed to deduct the non-excludable portions of part of the discharged indebtedness, namely the $55,337.44 in interest and $57,875.91 in attorney fees, the Robinsons should be allowed to deduct an additional 24.241% of these amounts.

III.

THE ROBINSONS' CROSS-APPEAL

A.

THE ALLOCATION OF THE SETTLEMENT PROCEEDS

The Robinsons contend that the Tax Court erred in reallocating the settlement proceeds among the various types of damages that they suffered. They argue that the Tax Court failed to give "proper regard" to the state court trial judge's allocation of ninety-five percent of the settlement proceeds to mental anguish and five percent to lost profits.

Although the Tax Court is not bound by a state court's allocation of settlement proceeds, it must give "proper regard" to allocations made by state courts when such allocations are entered by the court in a bona fide adversary proceeding.[6] In the case at bar, however, the Tax Court found that the allocation was not entered in a bona fide adversary proceeding. Further, it

found that the state trial court simply "rubber stamped" a judgment drafted by the Robinsons' attorneys. Therefore, the Tax Court did not consider itself bound by the state court's allocation, and reallocated the settlement proceeds.

[2] The Tax Court's findings that the allocation was not entered into in an adversary proceeding and that the judgment was simply "rubber stamped" by the state court are findings of fact, which this Court will only disturb upon a finding of clear error.[7] We hold that the trial court did not err in its factual findings. The testimony of the attorneys who represented the Robinsons in their suit against the bank supports the Tax Court's finding that the bank allowed the Robinsons to allocate the settlement proceeds in any manner they wished.[8] This testimony alone supports a finding that the Robinsons and the bank were not adversarial in the allocation of the settlement proceeds. The circumstances surrounding the state court judge's entry of judgment also support the trial court's findings. The parties presented the final judgment to the trial judge at his home in the evening. The meeting at the judge's home lasted no longer than one hour, and neither the final judgment nor the settlement agreement were discussed in detail during that meeting. Therefore, the Tax Court did not err in failing to give proper regard to the state court judgement's allocation of settlement proceeds.

[3] The Tax Court also did not err in its allocation of the proceeds. Its allocation was based upon the jury verdict, the best indication of the worth of the Robinsons' claims. We therefore affirm the

Tax Court's reallocation.

B.

REFUSAL TO SUBPOENA THE STATE COURT JUDGE

[4] The Robinsons contend that the Tax Court erred in refusing to allow them to subpoena the state court judge to testify as to his understanding and knowledge of the final judgment and what went into its determination. The Robinsons served a subpoena on the state court judge, who in turn moved to quash the subpoena on the ground that the taxpayers sought to question him regarding the mental processes employed by him in entering the Final Judgment. The Tax Court quashed the subpoena. We review the Tax Court's quashing of the subpoena for abuse of discretion.[9]

[5,6] A judge may not be asked to testify about his mental processes in reaching a judicial opinion.[10] The sole reason that the Robinsons attempted to subpoena the state court judge was to show that he considered the merits of the allocation contained in the Final Judgment rather than simply rubber stamping a judgment drafted by the Robinsons. There is no way that the trial judge could be asked about such matters without inquiring into his mental processes. In fact, the whole purpose of the subpoena was to delve into the judge's mental processes. Therefore, we hold that the Tax Court did not err in quashing the subpoena.

C.

REFUSAL TO REOPEN THE RECORD

The Robinsons contend that the Tax Court erred in refusing to reopen the record to allow them to present evidence of deductions that offset the discharge-of-indebtedness income. When the evidence revealed that the Robinsons received a release of a $691,971 judgment that the bank held against the Taxpayers, the Tax Court allowed the Commissioner to amend his pleading to assert the additional discharge-of-indebtedness income. The Robinsons then moved that the record be left open for additional submissions on the issue. The Tax Court denied the motion, and later denied a motion made by the Robinsons to reopen the record for submission of evidence of offsetting deductions.

[7] The Tax Court's denial of a motion to reopen the record for admission of additional evidence is "not subject to review except upon a demonstration of extraordinary circumstances which reveal a clear abuse of discretion."[11] Further, such motions should be denied where the evidence to be presented was available at trial, or could have been obtained with reasonable diligence.[12]

[8] We hold that the Tax Court did not err in denying the motion to reopen because, through the exercise of reasonable diligence, the Robinsons could have obtained the evidence of offsetting deductions. The Robinsons were made aware---through both the Commissioner's interrogatories propounded to them during discovery and through the evidence obtained during the depositions of the attorneys that represented the Robinsons in the state court litigation---that discharge-of-indebtedness income was an issue in the case. Therefore, they should

have obtained evidence of offsetting deductions before the close of trial.

IV.

CONCLUSION

We REVERSE the Tax Court's judgment to the extent that it held that the punitive damages portion of the settlement proceeds were excludable under Section 104(a)(2), REMAND this case to the Tax Court for entry of a judgment in accorance with this opinion, and AFFIRM the remainder of the Tax Court's opinion.

END NOTES

1. 26 U.S.C. Section 104(a)(2).

2. The Tax Court held that 100% of the amount allocated to prejudgment interest was includable in income.

3. 26 U.S.C. Section 104(a)(2).

4. *Estate of Moore v. Commissioner,* 53 F.2d 712, 716 (5th Cir.1995).

5. The Tax Court held that 100% of the prejudgment interest was included in income. The Robinsons did not appeal this holding.

6. *Cf. Commissioner of Internal Revenue v. Estate of Bosch,* 387 U.S. 456, 463-64, 87 S.Ct. 1776, 1781-82, 18 L.Ed.2d 886 (1967) (quoting S. REPT. No. 1013, 80th Cong. 2d Sess., pt. 2, at 4 (1948)).

7. *Switzer v. Wal-Mart Stores, Inc.,* 52 F.3d 1294, 1298 (5th Cir.1995).

8. The Robinsons' lead counsel testified as follows:

> I asked [the Bank's counsel], would there be any objection on their part on how [a settlement] would be structured if we went in and set the [judgment based on the injury verdit] aside. He said, "None."
>
> He said, "We don't care how you do it, just so it is paid and we can get it over with, and we will cooperate with you in any way you see fit. If you can get any tax benefit, fine." If you-you know, he didn't have any ax to grind. He didn't care. He made it plain.

9. *Tiberi v. CIGNA Ins. Co.*, 40 F.3d 110, 112 (5th Cir.1994).

10. *Washington v. Strickland*, 693 F.2d 1243, 1263 (5th Cir.1982), *rev'd on other grounds*, 466 U.S. 668, 104 S.Ct. 2052, 80 L.Ed.2d 674 (1984). *See United States v. Morgan*, 313 U.S. 409, 421-22, 61 S.Ct. 999, 1004-05, 85 L.Ed. 1429 (1941).

11. *Devore v. Commissioner*, 963 F.2d 280, 282 (9th Cir.1992).

12. *See, e.g., Tweeddale v. Commissioner*, 841 F.2d 643, 646 (5th Cir.1988).

APPENDIX B

EDWARD E. ROBINSON AND SANDRA ROBINSON, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT; Docket No. 24665-91 (United States Tax Court). Filed February 2, 1994.

Ps filed a lawsuit against Bank (B) alleging that B failed improperly to release its lien on Ps' property. Following a jury verdict for Ps totaling approximately $60 million, which include $6 million for lost profits, $1.5 million for mental anguish, and $50 million for punitive damages, Ps and B agreed to settle the lawsuit for $10,691,972.43. In connection with their settlement, Ps prepared unilaterally a final judgment allocating 95 percent of the settlement proceeds to tortlike personal injuries; the final judgment was entered by the trial court in accordance with the settlement. *Held*, the Court is not bound by the allocation of damages in the final judgment, and must determine the portion of the settlement proceeds that was attributable to Ps' tortlike personal injuries. *Held, further*, the portion of the settlement proceeds attributable to Ps' tortlike personal injuries (and excludable from Ps' gross income under sec. 104(a)(2), I.R.C.) equals 37.331 percent.

John A. Townsend, for petitioners.[1]
Ansley Acree and Gerald Brantley, for respondent.

LARO, *Judge*: This case is before the Court pursuant to a petition filed by Edward E. Robinson and Sandra Robinson (petitioners) for a redetermination of respondent's determination reflected in her notice of

deficiency issued to them on July 25, 1991. Respondent's notice of deficiency reflected her determination of deficiencies in petitioners' 1987 and 1988 Federal income taxes equal to $1,579,549 and $90,800, respectively.

A trial was held on this matter on February 23, 1993, in Houston, Texas. At the conclusion of the trial, the Court allowed respondent to amend her answer to conform to the evidence presented at the trial. Respondent alleged in her amendment that petitioners failed to report on their 1987 Federal income tax return $691,972.43 in additional settlement proceeds that petitioners "received" through a release of a judgment that they owed to the payor of the settlement.

The primary issue for decision is what portion of certain settlement proceeds that petitioners received in 1987 is excludable from their gross income under section 104(a)(2).[2] Petitioners contend that 95 percent of these proceeds is excludable from their gross income because the final judgment reflecting the settlement (final judgment) attributed the recovery of 95 percent of the proceeds to tortlike personal injuries. Respondent determined that 5 percent of these settlement proceeds was excludable from gross income; in her mind, the final judgment was insignificant because: (1) It did not reflect accurately the underlying settlement, and (2) the trial court did not independently review the allocation contained therein, and merely "rubber stamped" petitioners' out-of-court agreement. We agree with respondent that the allocation in the final judgment does not control this case and sustain her determination that petitioners reported

erroneously that only 5 percent of the settlement proceeds was includable in their 1987 gross income. We disagree with respondent, however, that 95 percent of the proceeds is includable in petitioners' gross income; we find that petitioners must include 62.669 percent of the settlement proceeds in their gross income.

As a secondary issue, we must decide whether petitioners had additional income of $691,972.43 in 1987, resulting from the release of the judgment that they owed the payor of the settlement. With regard to this issue, we conclude that petitioners had additional income in 1987 of $433,652.20; i.e., 62.669 percent of $691,972.43. We also conclude that petitioners may deduct, for 1987, related expenses of $70,949.67.[3]

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations and exhibits attached thereto are incorporated herein by this reference. Petitioners were husband and wife during the taxable years in issue; they resided in Texas at the time they filed their petition. Petitioners filed 1987 and 1988 Forms 1040, U.S. Individual Income Tax Return, using the status of "Married filing joint return".

In 1981, petitioners decided to open a furniture store in Hidalgo County, Texas, with a building that would be the largest furniture showroom in South Texas. Petitioners contracted with a builder to construct the building and obtained financing from Texas Commerce Bank-McAllen (bank). Petitioners initially borrowed $1,514,570 from bank; this initial loan was reflected in a deed of trust dated March 1, 1982.

Petitioners subsequently borrowed $1,580,753.76 from bank to extend their initial loan; this subsequent loan was reflected in a deed of trust dated December 14, 1982. (Hereinafter, the initial and subsequent loans are collectively referred to as the construction loans.) The construction loans were secured solely by the building under construction and the underlying property. (Hereinafter, the building under construction and the underlying property are collectively referred to as the business property.)

In or about September 1982, after petitioners' furniture business had opened, bank entered into a contract with petitioners under which bank granted petitioners $165,000 in letters of credit to purchase inventory for their furniture business. Petitioners collateralized the letters of credit with a deed of trust on Bonanza, petitioners' real property unrelated to the business property; bank placed a lien on Bonanza. Bonanza was valued at $425,000 at the time of collateralization, was owned by petitioners as a "reserve' to assist them in troubled economic times, and was unencumbered immediately before this collateralization.

Petitioners paid off the $165,000 indebtedness in or before February 1983, and, in so doing, satisfied the terms of the letters of credit. As a result thereof, bank should have released its lien on Bonanza. Bank failed to do so.

Petitioners' furniture business experienced difficulties.[4] Faced with serious cash-flow problems, petitioners attempted to neutralize these problems by either selling Bonanza or borrowing against

it. Petitioners learned at this time that bank had not released its lien on Bonanza, and asked bank to do so. Bank did not release its lien. Petitioners subsequently repeated their request on numerous occasions. Bank refused to honor any of these subsequent requests.[5]

Bank's refusal to release its lien on Bonanza devastated petitioners; their "reserve" was inaccessible to relieve the financial troubles of their business, and their business credibility with their suppliers was destroyed. Petitioners' furniture business failed, they were forced to sell inventory and other property at large losses, and they were driven into bankruptcy. In addition, Sandra Robinson developed severe psychological problems and required hospitalization.

On July 6, 1984, petitioners filed a complaint in the 206th District Court of Hidalgo County, Texas, against bank and its parent corporation, Texas Commerce Bancshares, Inc. (Commerce). (Hereinafter, unless otherwise noted, bank and Commerce are collectively referred to as defendants.) The nub of petitioners' complaint against defendants was that defendants failed improperly to release their lien on Bonanza, and, as a result thereof, prevented petitioners form obtaining funds necessary to maintain their furniture business. Defendants' failure to release the lien, petitioners claimed, ultimately forced them to close their furniture business and damaged them in their business and personal affairs.

On June 3, 1986, bank foreclosed on the business property. At the time of foreclosure, the amount due on the

construction loans was $2,053,759.08. A nonjudicial foreclosure sale of the business property was held on the same day as the foreclosure; the business property was sold at the sale for $1,475,000, and the sale price was applied against the amount due on the construction loans, leaving a deficiency of $578,759.08.

On April 13, 1987, a jury trial commenced in petitioners' lawsuit against defendants; Judge Joe B. Evins presided. At this time, petitioners' most recent pleadings were their: (1) Second amended original petition and (2) first supplemental petition and answer. Petitioners' second amended original petition alleged, in part, that defendants' failure to release the lien on Bonanza was willful, an act of malice and in reckless and conscious disregard of petitioners' rights, unconscionable, based on false representations, tortious, and a cloud on title.[6] Petitioners prayed for the following damages: (1) Lost profits of $20 million, (2) $250,000 for losses that petitioners incurred on the forced sales of properties other than Bonanza, (3) $200,000 for amounts incurred by petitioners for their futile attempt to save their business, (4) $5 million for severe mental anguish suffered by petitioners before trial, (5) $5 million for future severe mental anguish of petitioners, and future damage to petitioners' reputations, (6) exemplary (punitive) damages of five times the amount of actual or compensatory damages awarded in the case, (7) attorney's fees as proven at trial, (8) prejudgment interest as authorized by the Texas Supreme Court, (9) postjudgment interest as applicable, (10) their court costs, (11) all damages allowed by the Texas Deceptive Trade Practices Act, and (12) that

the lien on Bonanza be declared null and void, and of no force and effect, thereby removing the cloud on the title to Bonanza.[7]

After both sides rested, approximately 1 month after the trial began, the trial court granted a motion for directed verdict in favor of Commerce; it was dismissed from the action. Shortly thereafter, on May 11, 1987, petitioners' case against bank was submitted to the jury.

On May 12, 1987, the jury returned its verdict.[8] The jury found that: (1) Petitioners did not expressly or impliedly agree to give bank a lien on Bonanza for the construction loans; (2) bank made fraudulent misrepresentations; (3) bank's fraudulent misrepresentations were the proximate cause of damages to petitioners; (4) a special relationship existed between petitioners and bank; (5) bank did not act in good faith in its dealings with petitioners during the time in issue there; (6) bank's failure to act in good faith was the proximate cause of petitioner's damages; and (7) bank's conduct was intentional, willful, and in wanton disregard of petitioners' rights.

The jury awarded petitioners the following damages: (1) $1 million in pretrial lost profits, (2) $5 million in posttrial lost profits, (3) $175,000 in out-of-pocket and actual damages, (4) $85,000 in pretrial damage to petitioners' credit reputations, (5) $500,000 for past mental anguish of Sandra Robinson, (6) $500,000 for future mental anguish of Sandra Robinson, (7) $250,000 for past mental anguish suffered by Edward Robinson, (8) $250,000 for future mental anguish of Edward Robinson, (9) $1.5 million in attorney's fees, and (10) $50

million in punitive damages. On May 18, 1987, petitioners filed a motion for judgment on the verdict; the trial court granted this motion on May 20, 1987, and entered a judgment on the verdict accordingly. Further, the trial court found, and included in its entered judgment, that: (1) Petitioners were entitled to $881,919.61 in prejudgment interest, (2) bank was entitled to a counterclaim (by way of setoff) of $691,972.43, (3) bank was liable for all court costs, and (4) postjudgment interest would accrue at 10 percent per annum.[9]

After the verdict, and continuing after the judgment was entered on May 27, 1987, bank attempted to eliminate or mitigate the effect of the jury verdict through posttrial pleadings and settlement discussions. Petitioners and bank each hired prominent attorneys to represent then in these posttrial proceedings and to represent them in a possible appeal; both sides anticipated that bank would appeal if the matter was not settled in posttrial proceedings, and petitioners had the right to appeal the trial court's dismissal of Commerce. Bank's posttrial pleadings included separate motions for a new trial, to reform the judgment, and for judgment notwithstanding the verdict.

Between May 20, 1987,and July 30, 1987, counsel for petitioners and bank engaged in settlement discussions.[10] Petitioners and bank both wanted to avoid the expense, difficulty, and uncertainty of an appeal. From petitioners' point of view, they were also interested in settling their dispute with bank because they wanted to receive their recovery quickly. In addition, petitioners were informed by their counsel there that the award of $50 million in

punitive damages was the result of a "runaway jury", and would most likely be vacated or reduced upon appeal.[11]

On July 30, 1987, after the trial court heard bank's motion for a new trial, petitioners and bank agreed to settle their dispute.[12] Immediately after accepting bank's offer, petitioners and bank announced to the trial court that they had reached a settlement on the case. The terms of the settlement were that bank would pay petitioners $10 million in cash in exchange for petitioners' providing bank a complete release from any further liability on all claims that petitioners had against bank or Commerce. In addition, bank would release its judgment against petitioners in the amount of $691,972.43, and would work with petitioners on the allocation of the settlement proceeds to minimize petitioners' Federal income tax liability. Bank knew that petitioners wanted to allocate any settlement proceeds in a manner that would minimize their taxes, and did not care about the manner of allocation. Bank agreed with petitioners that they could allocate the settlement proceeds in any manner that petitioners desired.

In connection with their settlement, petitioners and bank executed a compromise agreement (settlement agreement), entitled Full land Final General Release and Agreement. The settlement agreement did not contain an allocation of the $10 million payment or reference the $691,972.43 judgment awarded to bank against petitioners. Petitioners subsequently prepared the final judgment and presented it to bank's representatives; petitioners and bank later presented the final judgment to Judge Evins

at his home for his signature. The meeting at Judge Evins' home started late in the evening and lasted no longer than 1 hour; neither the final judgment nor the settlement agreement was discussed in detail.

The final judgment was entered by the trial court on July 31, 1987, and vacated the judgment entered on May 20, 1987. The final judgment incorporated the settlement agreement by reference, and allocated 95 percent of the $10 million payment in the settlement agreement to mental anguish and 5 percent to pretrial lost profits.[13] Petitioners' counsel determined this allocation solely to minimize the amount of taxes that petitioners would have to pay on the settlement proceeds.[14] Petitioners' counsel intended that the 5-percent allocation to lost profits would be the starting point for petitioners to negotiate with respondent as to the amount of taxes payable on the settlement proceeds.

By check dated August 4, 1987, petitioners received their share of the $10 million payment; i.e. $4,935,151.72; the balance of the $10 million payment, $5,064,848.28, went to petitioners' attorneys. Petitioners reported $246,758 of the settlement proceeds, or 5 percent of $4,935,151.72, on their 1987 Form 1040 as miscellaneous income.[15] Petitioners did not report any portion of the $691,972.43 release on their 1987 Form 1040.[16]

OPINION

The burden of proof is on petitioners to show that respondent's determinations set forth in her notice of deficiency are incorrect. Rule 142(a); *Welch v. Helvering*,

290 U.S. 111, 115 (1933). Respondent bears the burden of proving the increase in the deficiency asserted in her amended answer. Rule 142(a); *Estate of Bowers v. Commissioner*, 94 T.C. 582, 595 (1990). We turn to the issues for decision.

1. Sections 61(a) and 104(a)(2)

Section 61(a) generally requires that individual taxpayers include in their gross income all income from whatever source derived, absent a contrary provision in subtitle A of the Internal Revenue Code (secs. 1 to 1563). The definition of gross income under section 61(a) sweeps broadly to encompass any accession to a taxpayer's wealth. *United States v. Burke*, 504 U.S.__, 112 S.Ct. 1867, 1870 (1992); *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). By contract, exclusions from gross income are matters of legislative grace and are construed narrowly in order to maximize the taxation of any accession to wealth. *United State v. Burke*, 504 U.S. at ___, 112 S.Ct. at 1878 (Souter, J., concurring in the judgment). Given the broad sweep of inclusions vis-a-vis the narrow construction of exclusions, it naturally follows that an accession to wealth is prima facie includable in gross income under section 61(a) unless a narrowly construed exclusion in sections 1 through 1563 clearly directs otherwise. *United States v. Burke*, 504 U.S. at ___, 112 S.Ct. at 1878 (Souter, J., concurring in the judgment.)

Petitioners claim that section 104(a)(2) is such an exclusion that clearly directs otherwise. Under section 104(a)(2) gross income does not include the amount of any damages received (whether by suit or

agreement) on account of personal injuries or sickness. From that section, and the regulations thereunder, we understand that damages received through a settlement of a lawsuit are excludable from gross income only if the damages were received on account of a "tortlike personal injury". For this purpose, no distinction is drawn between tortlike personal injuries that are physical versus tortlike personal injuries that are nonphysical (i.e., psychological). *Threlkeld v. Commissioner*, 87 T.C. 1294, 1297 (1986), affd. 848 F.2d 81 (6th Cir. 1988); *Seal v. Commissioner*, 58 T.C. 32,40 (1972); see also *United States v. Burke*, 504 U.S. at ____, 112 S.Ct. at 1871-1872. Thus, for example, damages are excludable from gross income under section 104(a)(2) if the damages were received pursuant to a settlement of a tortlike personal injury that results in: (1) Mental anguish, *Threlkeld v. Commissioner*, *supra* at 1297; *Church v. Commissioner*, 80 T.C. 1104, 1110 (1983); *Seay v. Commissioner*, *supra* at 37-38; see also *United States v. Burke*, 504 U.S. at ____, 112 S.Ct. at 1871-1872; (2) injury to reputation, *Threlkeld v. Commissioner*, *supra*; or (3) punitive damages, *Horton v. Commissioner*, 100 T.C. 93, 96 (1993); see also *Miller v. Commissioner*, 93 T.C. 330, 337-342 (1989), revd. 914 F.2d 586 (4th Cir. 1990).[17] On the other hand, damages are not excludable from gross income under section 104(a)(2) if, for example, the damages were received pursuant to the settlement of economic rights arising out of a contract (e.g., lost profits). Sec. 104(a)(2); *Stocks v. Commissioner*, 98 T.C. 1, 9 (1992); *Downey v. Commissioner*, 97 T.C. 150, 160 (1991), adhered to on reconsideration 100 T.C. 634 (1993); sec. 1.104-1(c), Income Tax Regs.; see also *United States v. Burke*, 504 U.S. at

____, 112 S.Ct. at 1870-1871 ("A 'tort' has been defined broadly as a civil wrong, other than breach of contract, for which the court will provide a remedy in the form of an action for damages" (quotation marks and citation omitted)). Amounts received on account of a tortlike personal injury are also not excludable from gross income under section 104(a)(2) if the amounts were received as statutorily imposed interest. *Kovacs v. Commissioner*, 100 T.C. 124, 130 (1993).

In the context of a settlement agreement, the nature of the claim underlying the taxpayer's damages award, rather than the validity of his or her claim, determines whether he or she received the damages on account of tortlike personal injuries. *United States v. Burke*, 5054 U.S. at ____, 112 S.Ct. at 1872; *Stocks v. Commissioner*, *supra* at 10; *Downey v. Commissioner*, 97 T.C. at 161; *Metzger v. Commissioner*, 88 T.C. 834, 847 (1987), affd. without published opinion 845 F.2d 1013 (3d Cir. 1988); *Bent v. Commissioner*, 87 T.C. 236, 244 (1986), affd. 835 F.2d 67 (3d Cir. 1987). Such a determination is factual and is generally made by reference to the settlement agreement in light of the surrounding circumstances. *Knuckles v. Commissioner*, 349 F.2d 6109, 613 (10th Cir. 1965), affg. T.C. Memo. 1964-33; *Stocks v. Commissioner*, *supra* at 10; *Seay v. Commissioner*, *supra* at 37; *Miller v. Commissioner*, T.C. Memo. 1993-49 (on remand), supplemented by T.C. Memo. 1993-588. A key question to ask is: "In lieu of *what* were the damages awarded?" *Raytheon Production Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir. 1944) (quoting *Farmers' Merchants' Bank v. Commissioner*, 59 F.2d 912 (6th Cir. 1931); emphasis added), affg. 1

T.C. 952 (1943); see also *Getty v. Commissioner*, 913 F.2d 1486, 1490 (9th Cir. 1990), revg. 91 T.C. 160 (1988); *Church v. Commissioner, supra* at 1107.

When the settlement agreement allocates clearly the settlement proceeds between tortlike personal injury damages and other damages, the allocation is generally binding for tax purposes (and the tortlike personal injury damages are excludable under section 104(a)(2) to the extent that they agreement is entered into by the parties in an adversarial context at arm's length and in good faith. *Threlkeld v. Commissioner*, 87 T.C. 1294, 1306-1307 (1986), affd. 848 F.2d 81 (6th Cir. 1988); *Fono v. Commissioner*, 79 T.C. 680, 694 (1982), affd. without published opinion 749 F.2d 37 (9th Cir. 1984); see also *Mitchell v. Commissioner*, T.C. Memo. 1990-617 (allocation of lump-sum payment in settlement document was not binding where taxpayer drafted the document without the participation or approval of his adversary), affd. 992 F.2d 1219 (9th Cir. 1993). An important factor in determining the validity of the agreement is the "intent of the payor" in making the payment. *Knuckles v. Commissioner, supra* at 613; *Agar v. Commissioner*, 290 F.2d 283, 284 (2d Cir. 1961), affg. per curiam T.C. Memo. 1960-21; *Metzger v. Commissioner, supra* at 847-848. If the payor's intent cannot be clearly discerned from the settlement agreement, his or her intent must be determined from all the facts and circumstances of the case in issue there.[18] Factors to consider include the details surrounding the litigation in the underlying proceeding, the allegations contained in the payee's complaint and amended complaint in the underlying proceeding, and the arguments made in the

underlying proceeding by each party there. See, e.g., *Estate of Morgan v. Commissioner*, 332 F.2d 144, 150-151, (5th Cir. 1964), affg. in part and revg. in part 37 T.C. 31 (1961); *Threlkeld v. Commissioner, supra* at 1306; *Bent v. Commissioner, supra* at 245. None of these factors is always outcome-determinative; in a given case, any of these factors may ultimately be persuasive or ignored. *Threlkeld v. Commissioner, supra* at 1306.

With these principles in mind, we proceed to analyze the settlement agreement and the final judgment.

2. Allocation of Damages in the Settlement Agreement and the Final Judgment.

The settlement agreement contains no allocation of the settlement proceeds; the final judgment does. Petitioners contend that the allocation in the final judgment dictates the treatment of their recovery for Federal income tax purposes. In particular, petitioners contend, Judge Evins, petitioners, and bank were in the best position to make a good faith assessment of the damages suffered by petitioners as a result of bank's conduct, and the allocation in the final judgment was made by them in good faith and based on the facts and law as each person knew them to be. Accordingly, petitioners conclude, this Court and respondent are bound by their allocation absent proof by respondent that the allocation was made in bad faith.

We disagree with petitioners' contentions.[19] The record does not support petitioners' claim that they, Judge Evins, and bank each assessed the damages and

allocated petitioners' recovery accordingly. The events preceding the execution of the settlement agreement indicate that petitioners and bank wanted to avoid the expense, difficulty, and uncertainty of an appeal. These events also indicate that bank wanted to settle all claims asserted by petitioners in their second amended original petition, and do not indicate that, in agreeing to the terms contained in the settlement agreement and the final judgment, bank intended to settle one claim to the exclusion of another.[20] Further, counsel for petitioners and bank did not discuss the merit of any particular claim; they merely agreed to a $10 million payment (and forgiveness of bank's judgment) in satisfaction of all of petitioners' claims against defendants.

The record indicates that bank offered to settle the case for $10 million and forgiveness of its judgment against petitioners; this was all bank would concede. Bank was not concerned with the amount of the settlement proceeds that was allocated to tortlike personal injury damages vis-a-vis other damages. From petitioners' point of view, however, the allocation was critical to their after-tax recovery; i.e. petitioners would be taxed on their receipt of the settlement proceeds to the extent that the proceeds were not allocated to tortlike personal injuries. Secs. 61(a), 104(a)(2). Petitioners therefore desired, and were given, the unfettered discretion to allocate the settlement proceeds in any manner they desired in order to minimize their Federal income tax liability. We find that petitioners deliberately and unilaterally arrived at the allocations contained in the final judgment solely with a view to Federal

income taxes, and not to reflect the realities of their settlement.

We also disagree with petitioners that the record indicates that Judge Evins made an independent review of the allocation of damages. The parties came to his house with an agreed settlement, and he entered the judgment agreed to by the parties. Contrary to petitioners' request, this Court will not blindly accept the terms contained in a settlement agreement, especially when the circumstances behind the agreement indicate that the allocation of the amounts contained therein was uncontested, nonadversarial, and entirely tax-motivated.

Petitioners argue that this Court, as well as other Federal courts, is precluded from challenging the allocations contained in the final judgment because the State trial court has determined petitioners' rights and included its determination in the final judgment. According to petitioners, they must prevail in this matter even if the Court finds that the allocation in the final judgment is an incorrect allocation. To support their argument, petitioners cite *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), and the interpretation and application of *Bosch* by the Court of Appeals for the Fifth Circuit in *Estate of Warren v. Commissioner*, 981 F.2d 776 (5th Cir. 1993), revg. and remanding 93 T.C. 694 (1989), and *Brown v. United States*, 890 F.2d 1329 (5th Cir. 1989).

We disagree with petitioners that this trilogy of cases resolves the instant case in their favor. In *Commissioner v. Estate of Bosch*, 387 U.S. 456, 456-457 (1967), the Supreme Court considered two Federal estate

tax case that presented a common question: "Whether a federal court or agency in a federal estate tax controversy is conclusively bound by a state trial court adjudication of property rights or characterization of property interests when the United States is not made a party to such proceeding." In holding that neither a Federal court nor a Federal agency is so bound, the Court first noted that both state court proceedings were brought to affect directly the outcome of Federal estate tax liabilities in cases that were pending in this Court, and that the Commissioner was not a party to either of these State proceedings. *Id.* at 457, 463. Because the Commissioner was not a party in the State proceedings, the Court observed, neither res judicata nor collateral estoppel applied to the proceedings before the Court. *Id.* at 463.

In addition, the Court noted, the legislative history underlying the estate tax provision before the Justices need to be considered because the Court was interpreting a Federal taxation statute. Based on this legislative history, the Court observed that State court interpretations of a will should be given "proper regard" by a court if, and only if, the State court entered the interpretations " in a bona fide adversary proceeding." *Id.* at 463-464 (quoting S. Rept. 1013 (Part 2), 80th Cong., 2d Sess. 4 (1948)). As state by the Court:

We cannot say that the authors of this [legislative] directive intended that the decrees of state trial courts were to be conclusive and binding on the computation of the federal estate tax as levied by the Congress. If the Congress had intended state trial court determinations to have that

effect on the federal actions, it certainly would have said so--which it did not do. [*Commissioner v. Estate of Bosch*, 387 U.S. 456, 464 (1967).]

The Court then noted that, in cases of diversity jurisdiction, "while the decrees of lower state courts should be attributed some weight...the decision [is] not controlling... where the highest court of the State has not spoken on the point". *Id.* at 465 (quotations and citations omitted; ellipsis points and alteration in original). The Court concluded by stating:

This is not a diversity case but the same principle may be applied for the same reasons, viz., the underlying substantive rule involved is based on state law and the State's highest court is the best authority on its own law. If there be no decision by that court then federal authorities must apply what they find to be the state law after giving "proper regard" to relevant rulings of other courts of the State. In this respect, it may be said to be, in effect, sitting as a state court. [*Id.* at 465; emphasis omitted.]

Twenty-two years after *Estate of Bosch*, in *Brown v. United States*, 890 F.2d 1329 (5th Cir. 1989), the Court of Appeals for the Fifth Circuit applied *Estate of Bosch* in an income tax case. In *Brown*, Brown was the beneficiary and executor of his parents' estates; the Commissioner mailed him a notice of deficiency alleging that these estates had terminated for income tax purposes. Following this notice, Brown petitioned the Texas Probate Court for an order directing that the estates needed ongoing management and administration. In a nonadversarial

proceeding, in which the United States was not a party, the Probate Court entered an order authorizing Brown to continue managing the estates' assets until he determined unilaterally that the estates should be terminated. Brown later argued that this order was binding on both the Commissioner and the Federal trial court. *Id.* at 1333, 1341.

The Court of Appeals for the Fifth Circuit rejected Brown's argument. In so doing, the court stated that "The relevance of a state court's judgment to the resolution of a federal tax question will vary, depending on the particular tax statutes involved as well as the nature of the state proceeding that produced the judgment." *Id.* at 342. The court then observed that: (1) The Commissioner's notice of deficiency was issued before Brown petitioned the Texas Probate Court, (2) the United States was not a party in the probate proceeding, (3) the probate proceeding was nonadversarial, (4) Brown and the putative remaindermen were in agreement; thus, the Probate Court was not presented with all the relevant facts and differing views, and (5) the probate proceeding did not involve Texas State interests. *Id.* The court concluded that the Probate Court's order was entitled to little deference, adding that "Not only was there no genuine controversy involved, the Probate Court's order was unnecessary under the Texas Probate Code provisions relating to independent administrations." *Id.*

Most recently, in *Estate of Warren v. Commissioner*, 981 F.2d 776 (5th Cir. 1993), revg. and remaining 93 T.C. 694 (1989), the Court of Appeals for the Fifth Circuit applied *Estate of Bosch* in an estate tax

case. In *Estate of Warren*, the proper construction of a will was in dispute in the Texas Probate Court. The parties in the dispute agreed ultimately to settle their dispute; the Probate Court modified and approved the settlement, and entered an agreed final judgment. Subsequently, respondent asserted an estate tax deficiency against the estate, and based her determination on a position that differed from a provision of the Probate Court's final judgment. Following a petition to this Court, we agreed with respondent; in so doing, we determined that, under *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), we were not bound by the Probate Court's final judgment. The Court of Appeals for the Fifth Circuit disagreed; in reversing our decision, the court stated that:

> The record as a whole affirmatively demonstrates that the dispute was a truly adversarial, nontax one and that the parties reached an arms-length and bona fide settlement of that dispute that was essentially approved by the Probate Court, and that what the Charities received in the settlement and under the Probate Court judgment accrued to them by virtue and as a result of the bequest to them in Article V of the will. There is no substantial evidence in the record to sustain a contrary finding.*** [*Estate of Warren v. Commissioner*, 981 F.2d 776, 784 (5th Cir. 1993), revg. and remanding 93 T.C. 694 (1989); emphasis added.]

Applying this trilogy of cases to the instant case, we are not persuaded that petitioners should prevail. First, we note that res judicata or collateral estoppel does not apply to this case; respondent was not a

party to the lawsuit that resulted in the final judgment.[21] *Commissioner v. Estate of Bosch*, 387 U.S. 456, 463 (1967). In addition, the State trial court's decision is not the decision of the State's highest court; thus, the trial court's determination of State law is not per se conclusive of the determination of State law for Federal income tax purposes. *Id.* at 465. Notwithstanding that the State trial court's decision is not conclusive on State law, however, this Court will give "proper regard" to that court's interpretation of its State's substantive law. *Id.* at 465; accord *Estate of Hubert v. Commissioner*, 101 T.C. 314 (1993) (in considering an agreement settling a will contest in a State court proceeding, the Court reasoned that it was not required to give conclusive effect to the agreement under *Estate of Bosch*; the weight given to the settlement agreement was determined by the adversarial or nonadversarial nature of the State court proceeding). To this end, however, Judge Evins did not make an independent review of the allocation of the amounts in the final judgment. While the parties were adversarial with respect to the dollar amount contained in the final judgment, they were not adversarial on the issue of the allocation memoralized therein.

Second, petitioners' preparation of the final agreement was one-sided, and the final agreement was not the product of bona fide adversarial negotiations. Although the record shows that the State court proceedings between petitioners and bank were hotly contested and adversarial, the record also shows that the preparation of the final judgment was uncontested and nonadversarial. Accordingly, the Sate court was not presented with all the relevant facts and differing

views with respect to the settlement agreement or final judgment before Judge Evins signed the final judgment and entered it accordingly.

Third, petitioners have not demonstrated how the terms contained in the final settlement affected State interests, or whether State interests would have been disrupted if the final agreement was drafted differently. Given that the State of Texas does not have a State personal income tax, see generally 1 State Tax Guide (CCH) 1502 (2d ed. 1993), we are hard pressed to find a State interest that would have been affected by a contrary allocation in the final judgment. We find relevant the following statement by the Court of appeals for the Fifth Circuit in *Brown v. United States*, 890 F.2d 1329, 1342 (5th Cir. 1989): "the natural tendency of a busy [State] court is to accede to a proposed order without great deliberation when all known interested parties are in agreement and when state interests are not adversely affected."

In conclusion, the record shows affirmatively that the allocation in the final agreement was not a bona fide allocation that was reached at arms' length between petitioners and bank. The record also shows affirmatively that the allocation stemmed from the nonadversarial and uncontested preparation of the final judgment by petitioners, that they were tax motivated in making the allocation, and that they were tax motivated in making the allocation and that they considered the allocation to be a starting point in their anticipated future discussions with the Government over their 1987 Federal income tax liability.[22] Accordingly, we refuse to treat the

allocation in the final judgment as determinative of the matter before us.

3. Method of Allocation

The factual setting of the case at hand involves claims of both tort and breach of contract; the settlement proceeds must be apportioned between these two types of claims in order to determine the amount of the proceeds that are attributable to a tortlike personal injury and excludable under section 104(a)(2). Having rejected the allocation in the final judgment, we now proceed to determine the correct allocation.

We believe that the settlement proceeds should be allocated based on the relationship of certain amounts included in the judgment entering the jury verdict of May 20, 1987. The jury returned its verdict following a long and strenuous trial. Before reaching its verdict, the jury was instructed by Judge Evins on the relevant laws of Texas to be applied to the facts of the case. We believe that the jury verdict had a direct bearing on the bank's settlement payment to petitioners and should be taken into account in our apportionment of that settlement.

With respect to the punitive damages awarded by the jury, however, we believe that a slight modification is necessary for present purposes. Petitioners' counsel in the settlement discussions informed them that the punitive damages of $50 million were the result of a "runaway jury" and were likely to be reduced or eliminated upon appeal. We believe that petitioners and bank both anticipated a significant reduction in the punitive damage award in the event of appeal, and agreed to the terms of the settlement

agreement with this in mind. Accordingly, we first allocate the $10 million settlement payment (exclusive of the amount of the release) to the jury's award of contract and tort damages; afterwards, we allocate the remaining balance of the $10 million payment to punitive damages.[23]

Before allocating the $10 million payment among these components, we must first determine the amount of prejudgment interest that is included therein. The State trial court found that petitioners were entitled to $881,919.61 in prejudgment interest on the $59,260,000 jury verdict. Thus, based on this finding by the State trial court, we find that $146,640 of the $10 million payment to petitioners was prejudgment interest.[24] Accordingly, for purposes of our allocation, the "principal portion" of the settlement payment (exclusive of the amount of the release) is reduced to $9,853,360. To summarize, the $10 million settlement payment is allocated as follows:

	Damages	% of Damages
Actual damages:		
Lost profits	$6,000,000	60.893
Other business damages	175,000	1.776
Injury to credit reputations	85,000	.863
Mental anguish	1,500,000	15.223
Punitive damages	2,093,360	21.245
Settlement less prejudgment interest	9,853,360	100.000
Prejudgment interest	146,640	
Total settlement payment	$10,000,000	

As mentioned above, damages for tortlike

personal injuries include damages, damages for mental anguish, and damages for injury to reputation. In the case at hand, these three elements aggregate 37.331 percent of the damage award (i.e. 21.245+15.223+.863). Accordingly, petitioners may exclude 37.331 percent of the settlement payment from their gross income under section 104(a)(2); the balance of the payment is includable in petitioners' taxable income, section 61(a). In other words, petitioners' excludable portion of the settlement payment equals $1,787,599.30; i.e. 37.331 percent of the net payment (less prejudgment interest) of $4,788,511.72; the balance of the net payment (including prejudgment interest), $3,147,552.42, is includable in petitioners 1987 gross income.

4. Bank's Release of Judgment Against Petitioners.

In connection with the settlement of their lawsuit against bank, petitioners were released from bank's judgment against them in the amount of $691,972.43. As mentioned above, this judgment consisted of the $578,759.08 deficiency on the nonjudicial foreclosure sale of the business property, $55,337.44 in interest from the date of foreclosure to the date of judgment, and $57,875.91 for attorney's fees.

The parties agree that the portion of this release that is attributable to other than tortlike personal injuries is additional settlement proceeds that are includable in petitioners' gross income. See *supra* note 16. Hence, respondent has met her burden of proving $433,652.20 of the increase in the deficiency asserted in her amended answer. Rule 142(a); *Estate of Bowers v.*

Commissioner, 94 T.C. 582, 595 (1990). Stated differently, we require that petitioners include in their 1987 gross income the full amount of the release ($691,972.43), less the 37.331 percent portion that is attributable to tortlike personal injuries.

The parties also agree that petitioners may deduct the other than tortlike personal injury portions of the following amounts related to these additional settlement proceeds: (1) Interest of $55,337.44 and (2) attorneys' fees of $57,875.91. See *supra* note 16. Hence we allow petitioners to deduct $70,949.67 in 1987; i.e., 62.669 percent of the sum of these agreed amounts.

Notwithstanding these expenses for interest and attorney's fees, petitioners contend that they may deduct other expenses that would have been deductible had they actually paid the $578,759.08 deficiency. We reject this contention. Although petitioners may have been able to deduct additional expenses had they paid them, petitioners failed to prove at trial that they were entitled to any deductions in connection with the release, other than a portion of the interest expense of $55,337.44 and of the attorney's fees of $57,875.91 conceded by respondent.

We have considered all other arguments by the parties, and find them to be without merit.

For the foregoing reasons,

Decision will be entered under Rule 155.

END NOTES

1. Petitioners were represented by *John A. Townsend* until Oct. 26, 1993; at that time, the Court allowed Mr. Townsend to withdraw as petitioners' attorney of record.

2. Unless otherwise stated, all section references are to the Internal Revenue Code in effect for the taxable years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

3. Respondent adjusted petitioners' 1987 taxable income by increasing the amount of the settlement proceeds that petitioners reported in their gross income. As a result of this increase in petitioners' 1987 gross and taxable incomes, respondent also adjusted: (1)A medical expense deduction that they reported for 1987, and (2)a net operating loss (NOL) deduction that they reported for 1988, and that was attributable to the NOL they reported for 1987. Our resolution of the primary and secondary issues will necessitate a computational adjustment of petitioners' 1987 medical expense deduction and 1988 NOL deduction.

4. Petitioners' furniture store was located near the Mexican border, and catered to customers from both sides of the border. Contemporaneously with the opening of their store, the Mexican peso was devalued, and the business climate in the area deteriorated. In addition, persons from Mexico stopped crossing the border to patronize petitioners' store.

5. Texas Commerce Bank-McAllen (bank) contended that petitioners collateralized their loans of Mar. 1, 1982, and Dec. 14,

1982 (collectively referred to as the construction loans), with both: (1)The building under construction and the underlying property (collectively referred to as the business property) and (2)petitioners' other real property (Bonanza). As discussed below, a jury found subsequently that Bonanza was not collateral for the construction loans, and the failure of bank to release its lien on Bonanza upon petitioners' satisfaction of the underlying letters of credit was deliberate and wrongful.

6. Petitioners asserted the following breach of contract and tort claims in their lawsuit against bank and Texas Commerce Bancshares, Inc. (Commerce), bank's parent corporation (hereinafter, unless otherwise noted, bank and Commerce are collectively referred to as defendants): (1)Breach of defendants' contractual obligation to release the lien on Bonanza as required by the deed of trust, (2)breach of statutory and common law duties of good faith and fair dealing arising from defendants' breach of their contract with petitioners, (3) fraudulent misrepresentation, (4)conversion, and (5)slander of title.

7. In petitioners' memoranda of law filed with the Texas trial court, petitioners indicated that the lawsuit was brought partially under the Texas Deceptive Trade Practices Act in order to recover attorneys' fees. See Tex. Bus. & Com. Code Ann. sec. 17.50(d)(West 1987).

8. Judge Joe B. Evins later informed petitioners that their trial was one of the longest trials in which he had been involved, and that their trial was stressful

to him and to the members of the jury.

9. Bank's $691,972.43 judgment against petitioners was for the deficiency on the nonjudicial foreclosure sale of the business property ($578,759.08), interest from the date of foreclosure to the date of judgment ($55,337.44), and attorney's fees ($57,875.91).

10. During these discussions, petitioners were concerned with the amount of taxes that they would have to pay to the Government on the settlement proceeds. In connection therewith, petitioners sought expert advice on the tax consequences from the receipt of settlement proceeds.

11. Petitioners' counsel also informed petitioners of numerous cases in which Texas appellate courts vacated jury awards of large punitive damages.

12. Bank had previously offered to settle petitioners' lawsuit by paying them $10 million and forgiving its $691,972.43 judgment against petitioners, and had previously informed petitioners that this was bank's best settlement offer from petitioners' point of view. Bank had also offered, as part of this settlement, to allow petitioners to structure the settlement between taxable and nontaxable components in any manner that petitioners desired. In this Court, petitioners' lead counsel during the settlement discussions recounted these discussions as follows:

I asked [bank's counsel] would there be any objection on their part on how [a settlement] would be structured if we went in and set the [judgment based on the jury

verdict] aside. He said, None.

He said, We don't care how you do it, just so it is paid and we can get it over with, and we will cooperate with you in any way you see fit. If you can get any tax benefit, fine. if you-you know, he didn't have any ax to grind, and he didn't care. He made it plain.

13. The final agreement apportioned petitioners' recovery for mental anguish as follows: 50 percent to mental anguish that Edward Robinson had suffered in the past, and 50 percent to mental anguish that Sandra Robinson had suffered in the past.

14. Petitioners' counsel showed the final judgment to petitioners before presenting it to Judge Evins for his signature; petitioners wanted to verify that the tortlike personal injury allocation was contained in the final judgment. Petitioners believed at the time of the settlement agreement that damages awarded for mental anguish were excludable from income under sec. 104(a)(2) and wanted to avoid paying taxes on as much of the settlement as possible.

15. Taxpayers generally may deduct legal fees that are incurred in connection with a lawsuit to the extent that the fees are ordinary and necessary business expenses under sec. 162. Taxpayers may not deduct legal fees, however, to the extent that the fees are allocable to a class of income exempt from taxation. In the case of a settlement that includes damages both includable in income under sec. 61(a) and excludable from income under sec. 104(a)(2), the Court generally determines the deductibility of any underlying legal fees

by allocating the fees in the same proportion as the excludable and includable portions of the settlement. *Stocks v. Commissioner*, 98 T.C. 1, 18 (1992). Because respondent's determination was based solely on the net proceeds received by petitioners, and the parties have not raised the issue of the proper treatment of petitioners' legal fees, we limit our inquiry to the net settlement proceeds received by petitioners and do not address the deductibility of their legal fees.

16. Petitioners conceded on brief that the portion of the release that is attributable to other than tortlike personal injuries is additional settlement proceeds that are taxable to them. Respondent conceded on brief that petitioners may deduct the other than tortlike personal injury portions of the following amounts related to these additional settlement proceeds: (1)interest of $55,337.44 and (2)attorney's fees of $57,875.91. See *supra* note 9.

17. Sec. 7641(a) of the Omnibus Budget Reconciliation Act of 1989 (OBRA), Pub. L. 101-239, 103 Stat. 2106, 2379, amended sec. 104 to make its exclusion inapplicable to punitive damages received in cases not involving physical injury or sickness. This limitation is not applicable to the years in issue; the amendment is inapplicable to amounts received before July 11, 1989. OBRA sec. 7641(b); *Horton v. Commissioner*, 100 T.C. 93, 94 n.2(1993).

18. In the context of a damage award, the focus is on the basis on which the trier of fact awarded the damages. *Metzger v. Commissioner*, 87 T.C. 834, 848 (1987), aff'd. without published opinion 845 F.2d

1013 (3d Cir. 1988); *Bent v. Commissioner*, 87 T.C. 236, 245 (1986), aff'd 835 F.2d 67 (3d Cir. 1987); see also *Miller v. Commissioner*, T.C. Memo 1993-49 (on remand), supplemented by T.C. Memo 1993-588.

19. We quickly dispense with petitioners' contention that respondent must prove that the allocation in the final agreement was made in bad faith; as previously mentioned, petitioners generally bear the burden of proof in this Court. Although respondent bears the burden of proof in certain instances, see generally Rule 142(a) and (b); *Portillo v. Commissioner*, 932 F.2d 112;8, 1133 (5th Cir. 1991), affg. in part and revg. in part T.C. Memo 1990-68, the instant case is not one of those instances.

20. We note that, in agreeing to settle petitioners' lawsuit, bank never acknowledged or denied liability with respect to any of the claims.

21. Respondent also was not a party to the settlement discussions of petitioners and bank, or to the preparation of the allocation that was embodied in the final judgment.

22. The unreliability of the final agreement is detected quickly from the provision granting $4,750,000 in damages for past mental anguish suffered by Edward Robinson. Assuming arguendo that the jury verdict included punitive damages for Edward Robinson's mental anguish equal to those requested by petitioners (i.e., five times actual damages), the jury verdict would have included only $1,500,000 for Edward Robinson's past mental anguish.

23. We allocate no portion of the settlement payment to attorney's fees for the reasons stated *supra* note 15.

24. We have determined the prejudgment interest of $146,640 by deducing that (1) the prejudgment interest included in the $10 million payment, divided by (2) the $10 million payment less the amount of prejudgment interest included therein, is the same ratio as (1) the prejudgment interest awarded by the State trial court on the jury verdict, divided by (2) the jury verdict. In other words, mathematically speaking, assuming that the prejudgment interest included in the $10 million payment equals "x", the ratio is as follows:

$$\frac{X}{10{,}000{,}000 - x} = \frac{881{,}919.61}{59{,}260{,}000.00}$$

(2)

...e Court, U.S.
FILED
AUG 23 1996
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No. 95-2067

In the Supreme Court of the United States

OCTOBER TERM, 1995

EDWARD E. ROBINSON AND SANDRA ROBINSON,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether the courts below correctly allocated the proceeds of a settlement agreement between "damages received * * * on account of personal injuries" that are excluded from gross income under Section 104(a)(2) of the Internal Revenue Code, 26 U.S.C. 104(a)(2), and damages for non-personal injuries that are not within this statutory exclusion.

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-14a) is reported at 70 F.3d 34. The opinion of the Tax Court (Pet. App. 1b-34b) is reported at 102 T.C. 116.

JURISDICTION

The judgment of the court of appeals was entered on December 5, 1995. The petition for a writ of certiorari was filed on March 4, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners obtained a state court jury verdict against a bank for wrongful failure to release a lien.

The verdict included $6,000,000 for lost profits, $1,500,000 for mental anguish and $50,000,000 in punitive damages (Pet. App. 4a, 7b-8b). The bank filed a motion for a new trial. While that motion was pending, the parties conducted settlement negotiations. During these negotiations, petitioners' attorneys informed the bank that petitioners desired to allocate any settlement proceeds among their various damage claims in a manner that would minimize their tax liability. The bank's representatives stated that they had no objection to structuring a settlement to accomplish that goal. The bank's sole concern was to obtain a complete and final release from all possible claims arising from the matter (Pet. App. 4a, 8a, 13a, 8b-9b).

The parties thereafter entered into a final settlement agreement. Under that agreement, the bank paid petitioners $10,000,000 and released petitioners from a judgment of approximately $700,000. The parties prepared a stipulated judgment for entry by the district court that substituted the terms of the settlement for the jury verdict. The stipulated judgment stated that 95 percent of the settlement proceeds were allocated to mental anguish and 5 percent were allocated to lost profits (Pet. App. 4a, 9b-10b).

The parties presented the stipulated judgment to the judge at his home for his signature. The meeting at the judge's home started late in the evening and lasted no longer than one hour. Neither the final judgment nor the settlement agreement was discussed in detail. The form of judgment that the parties had prepared was signed and entered by the court at that time (Pet. App. 9b-10b).

After paying attorneys' fees and costs, petitioners received $4,935,152.43 of the settlement proceeds. Of that amount, petitioners reported only 5 percent, or $246,758, as income on their 1987 joint income tax return. They contended that the other 95 percent represented compensation for mental anguish and is excluded from income under Section 104(a)(2) of the Internal Revenue Code as "damages received * * * on account of personal injuries or sickness" (26 U.S.C. 104(a)(2)).

2. On audit, the Internal Revenue Service determined that 95 percent of the proceeds of the settlement was taxable income from non-personal injuries. Petitioners sought a redetermination of the resulting income tax deficiency in the Tax Court.

The Tax Court found that the allocation of the settlement proceeds contained in the stipulated state court judgment did not reflect the genuine nature of the damages that petitioners received. The court noted that petitioners had consciously allocated the settlement proceeds in a manner designed to minimize their tax liability, rather than to reflect the genuine nature of their claims. The court therefore reallocated the settlement proceeds based upon the award of damages entered by the jury in the state court suit. The fact that the jury verdict followed "a long and strenuous trial" indicated to the court that the verdict "had a direct bearing on the bank's settlement payment" (Pet. App. 24b). Petitioners had been advised by their counsel that the $50,000,000 punitive damage award was the result of a "runaway jury" and would most likely be vacated or reduced on appeal. The court found that "petitioners and bank both anticipated a significant reduction in the punitive damage award in the event of appeal, and agreed

to the terms of the settlement agreement with this in mind" (Pet. App. 24b-25b). The court therefore first allocated the settlement proceeds to the actual damages received, then to prejudgment interest, and finally the remainder to punitive damages (*ibid.*).

The court concluded that the amounts thus attributable to punitive damages, mental anguish and injury to credit reputation represent damages for personal injuries excluded from tax under Section 104(a)(2). The court held that the balance of the net payment to petitioners was includable in their gross income (Pet. App. 6a-7a).

3. The court of appeals upheld the Tax Court's allocation of the settlement proceeds. The court held that the allocation set forth in the stipulated state court judgment was contrived simply to avoid taxes and was not binding. The court of appeals agreed that the jury verdict was "the best indication of the worth of the Robinsons' claims" and therefore upheld the Tax Court's allocation of the settlement proceeds (Pet. App. 8a-9a).[1]

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

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[1] On the government's appeal, the court further held (Pet. App. 7a-8a) that the punitive damages do not represent compensation for personal injuries within the scope of the exclusion from income provided by Section 104(a)(2). The court therefore reversed the Tax Court's determination that the punitive damages allocated from the proceeds of the settlement are excluded from tax. Petitioners have not sought further review of that ruling.

1. The proper characterization and allocation of the proceeds of a settlement for federal income tax purposes is an inherently factual inquiry that is reviewable for clear error. *Knuckles* v. *Commissioner*, 349 F.2d 610, 612 (10th Cir. 1965); *Agar* v. *Commissioner*, 290 F.2d 283, 283 (2d Cir. 1961). The allocation made by the courts below in this case is supported by the record and is not clearly erroneous.

The record reflects that the allocation of proceeds set forth in the stipulated state court judgment—which assigned 95 percent of the settlement proceeds to mental anguish—did not reflect a genuine evaluation of the nature and strength of petitioners' claims. Instead, it represented an accomodation by the bank of petitioners' acknowledged attempt to minimize their federal income tax liabilities.[2] Because the allocation contained in the stipulated judgment was not the result of an arm's-length or adversarial evaluation of the nature of the underlying claims, the Tax Court properly looked to the state court jury verdict to determine the nature of the damages actually reflected in the settlement agreement. The court concluded that the jury verdict, which followed "a long and strenuous trial," "had a direct bearing on the bank's settlement payment" (Pet. App. 24b). That conclusion, and the resulting allocation of the settlement proceeds in this case, is not clearly erroneous. Further review of this factual determination, con-

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[2] During the course of the negotiations of the settlement agreement, petitioners' attorney informed the bank that petitioners desired to allocate the proceeds in a manner that would reduce their income tax obligations. The bank's representatives, on their part, had no objection to wording the stipulated judgment in a manner that would assist petitioners' tax strategy (Pet. App. 8a, 13a, 8b-9b).

curred in by both courts below, is not warranted. See *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985).

2. Petitioners err in contending (Pet. 9-16) that this Court's decision in *United States* v. *Burke*, 504 U.S. 229 (1992), requires the Commissioner to accept for tax purposes the allocation of damages contained in the stipulated state court judgment. Neither *Burke* nor the subsequent decision in *Commissioner* v. *Schleier*, 115 S. Ct. 2159 (1995), addresses the question of the amount of deference owed to a state court stipulated judgment in allocating damages between personal and non-personal injuries. As petitioners note (Pet. 18), however, in *Commissioner* v. *Estate of Bosch*, 387 U.S. 456 (1967), this Court stated that state court judgments are to be given "proper regard" in determining the federal income tax characterization of items of income. The courts below properly applied the standard described by this Court in *Estate of Bosch*.

The court of appeals summarized the evidentiary basis for rejecting any reliance on the stipulated judgment in determining the character of the damages awarded to petitioners (Pet. App. 9a):

> The testimony of the attorneys who represented the Robinsons in their suit against the bank supports the Tax Court's finding that the bank allowed the Robinsons to allocate the settlement proceeds in any manner they wished. * * * The circumstances surrounding the state court judge's entry of judgment also support the trial court's findings. The parties presented the final judgment to the trial judge at his home in the evening. The meeting at the judge's home lasted

> no longer than one hour, and neither the final judgment nor the settlement agreement were discussed in detail during that meeting. Therefore, the Tax Court did not err in failing to give proper regard to the state court judg[]ment's allocation of settlement proceeds.

As the Tax Court noted, the allocation of damages set forth in the stipulated state court judgment is entitled to no weight in determining federal tax consequences because that allocation "was uncontested, nonadversarial, and entirely tax-motivated" (Pet. App. 17b).

Nothing in *Estate of Bosch* supports the contention that an allocation contrived to avoid federal income tax consequences in a stipulated, non-adversary state court judgment is entitled to conclusive effect. The Court stated in *Bosch* that decisions of state trial courts are not binding in federal tax matters because only the highest court of a State can authoritatively interpret that State's law. 387 U.S. at 465. While stating that the decisions of state trial courts are nonetheless entitled to "proper regard," the Court pointed out that Congress intended such limited deference to apply only to decisions entered by a state court "in a bona fide adversary proceeding." *Id.* at 464. In *Bosch*, the Commissioner was not a party to the state proceedings, which were brought "for the purpose of directly affecting federal estate tax liability." *Id.* at 463. The Court held that the state trial court decrees in that case were therefore *not* conclusive for federal tax purposes. *Id.* at 466.

The reasoning applied by this Court in *Estate of Bosch* directly supports the decision in this case. The state court's approval of the allocation of the settle-

ment proceeds to mental anguish and lost profits is not controlling for federal tax purposes because the merits of that allocation were not contested or adjudicated in a bona fide adversary proceeding. The "proper regard" required under *Bosch* does not include the acceptance of a stipulated judgment that was negotiated, drafted and entered for the purpose of avoiding federal tax liabilities. 387 U.S. at 463. See also *id.* at 471 (Douglas, J., dissenting) ("[a] federal court might not be bound by a consent decree, for it does not purport to be a declaration of state law; it may be merely a judicial stamp placed upon the parties' contractual settlement"); *Brown* v. *United States*, 890 F.2d 1329, 1341-1342 (5th Cir. 1989) (under *Bosch*, nonadversarial state trial court decree that "had no practical consequences apart from this federal tax controversy" was not binding for federal tax purposes); *Bath* v. *United States*, 480 F.2d 289, 290-292 (5th Cir. 1973) ("in the light of the absence of true adversary litigation, [and] the total waiver of substantial defenses," probate court's holding in will contest that heir received share of estate as compensation for services was not controlling for federal tax purposes).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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